



*Osher Lifelong Learning Institute, June 2026*

## Contemporary Economic Policy

University of Minnesota

Host: Geoffrey Woglom, Director  
National Economic Education Delegation



## Course Schedule

### Contemporary Economic Policy

- Week 1 (6/3): Economic Update & Changes at the Fed, Geoffrey Woglom, Amherst College
- Week 2 (6/10): Federal Debt and Deficits, Kathryn Wilson Kent State University
- **Week 3 (6/17): Banking Crises, Gerard Caprio, Williams College**
- Week 4 (6/24): Saving Social Security, Geoffrey Woglom, Amherst College

## **Submitting Questions**

- **Submit questions in the chat or by raising your digital hand. We will do a verbal Q&A once the material has been presented.**
- **Slides will be available from the NEED website tonight or tomorrow [https://needecon.org/delivered\\_presentations.php](https://needecon.org/delivered_presentations.php).**

## **Banking Crises: A Hardy Perennial**

**Gerard Caprio**

**William Brough Professor of Economics,  
Emeritus**

**Williams College**

## Outline

- 1 Why Crises Matter...and Why So Many
- 2 Why Finance is Fragile
- 3 How Finance Gets Riskier
- 4 Regulating to mitigate crises
- 5 Lessons from past crises



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## Why crises matter

- **Impact on economy**
  - ✓ Loss of output, jobs, income
  - ✓ When debt/GDP high, reduce borrower net worth, cutting investment and consumption.
- **Impact on people: hurt the poor**
  - ✓ E.g., Dominican Republic, Argentina, Greece...
- **Frequency: crises keep recurring**
- **Contagion: from one market, sector or economy to others**

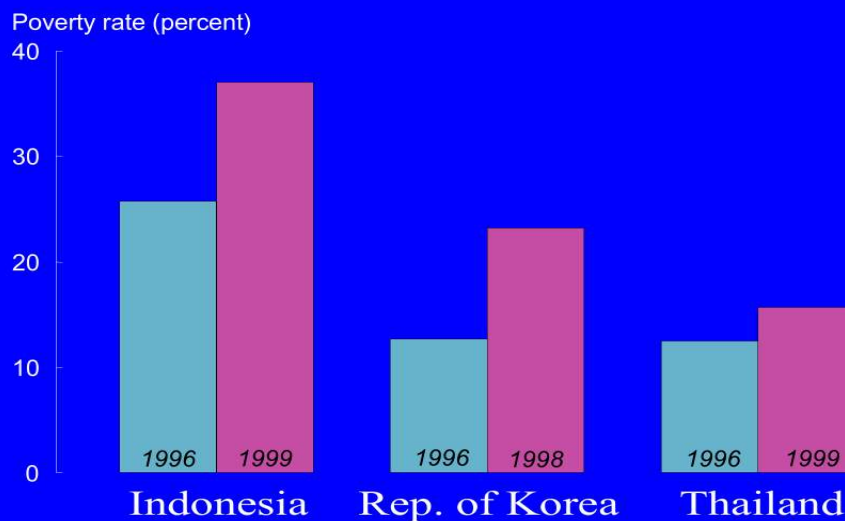


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## Why Crises Matter, cont.

- **Fallout:**
  - ✓ Public and private debt levels rise, sometimes to unsustainable levels
  - ✓ Other reform efforts may be slowed (e.g. banks lobby for suspension of climate regulations)
- **Lessons: crises often reveal weaknesses of financial system – who is ‘swimming naked’ (Warren Buffet)**
- **And crises can start outside the financial system**
  - ✓ Greece, Doom Loop

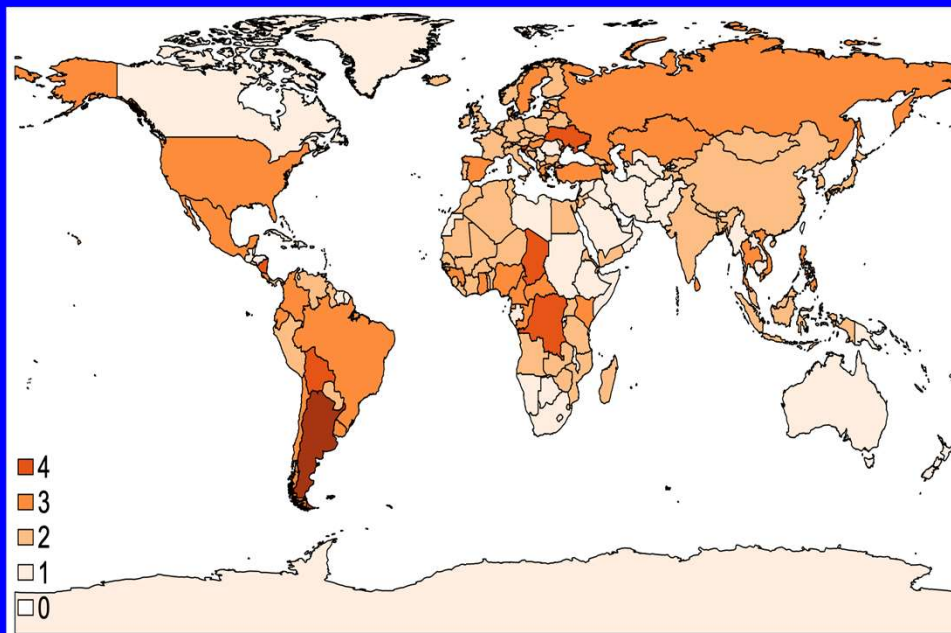
## East Asia crisis poverty rates had been declining sharply until 1997 crisis



## What is a Financial Crisis?

- **IMF:** A run on the currency, or on the banking system. The payments function is impaired
- **World Bank:** When the system is insolvent
  - ✓ Functions of finance impaired, development is set back
- **Fed view:** Financial instability occurs when problems (or concerns about potential problems) within institutions, markets, payments systems, or the financial system in general significantly impair the supply of credit intermediation services – impacts economic activity.
- When ‘the return of your money is more important than the return on your money.’  
Will Rogers

### Frequency of Systemic Crises, 1970-2024



## Why So Many Crises?

- **Regulation is difficult:**
  - ✓ CEO adage and information
- **Regulators might lack the tools, skills, incentives (SVB!)**
- **Private interest view – regulators can be influenced by regulatees (SVB - FRBSF?)**
- **Even when regulators are trying to improve social welfare, information problems affect them too**



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## Why So Many Crises II?

- **International coordination of financial regulation (e.g. the Basel Committee) might have made it worse!**
  - ✓ **With each new version of the Basel Approach, regulation is ever more complex**
  - ✓ **Complexity leaves more room for interpretation and evasion, harder to monitor.**



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## Why So Many Crises, III

- **Compensation can create spectacular rewards for risk taking**
  - ✓ **Result: more risks**
- **Broader point: finance changes all the time**
  - ✓ **Technology and regulations change**
  - "If you entrench yourself behind strong fortifications, you compel the enemy to seek a solution elsewhere."**  
**von Clausewitz**
- **So, regulation is a dynamic game**
  - ✓ **Therefore regulation has to adapt!**

## Why finance is fragile

- **Asymmetric and heterogeneous information**
  - **Individuals not fully rational in assessing risk**
    - ✓ **Framing affects decision –Kahneman and Tversky**
      - A: you win \$1000 with certainty
      - B: 50% chance of \$2500, or 0
      - C-- lose 1000 with certainty or
      - D-- lose 2500 with 50% probability
- A, D are the most popular choices – risk averse and risk loving alternatives

## Public Health Example

- Imagine the outbreak of an unusual disease, expected to kill 600 people. Pick a public health programs to combat it:

Program A: Save 200 lives,	$p = 1$
Program B: Save 600 lives,	$p = .33$
Save 0 lives,	$p = .67$
Program C: 400 people die,	$p = 1$
Program D: 0 die	$p = .33$
600 die	$p = .67$

(Note: A=C, B = D)



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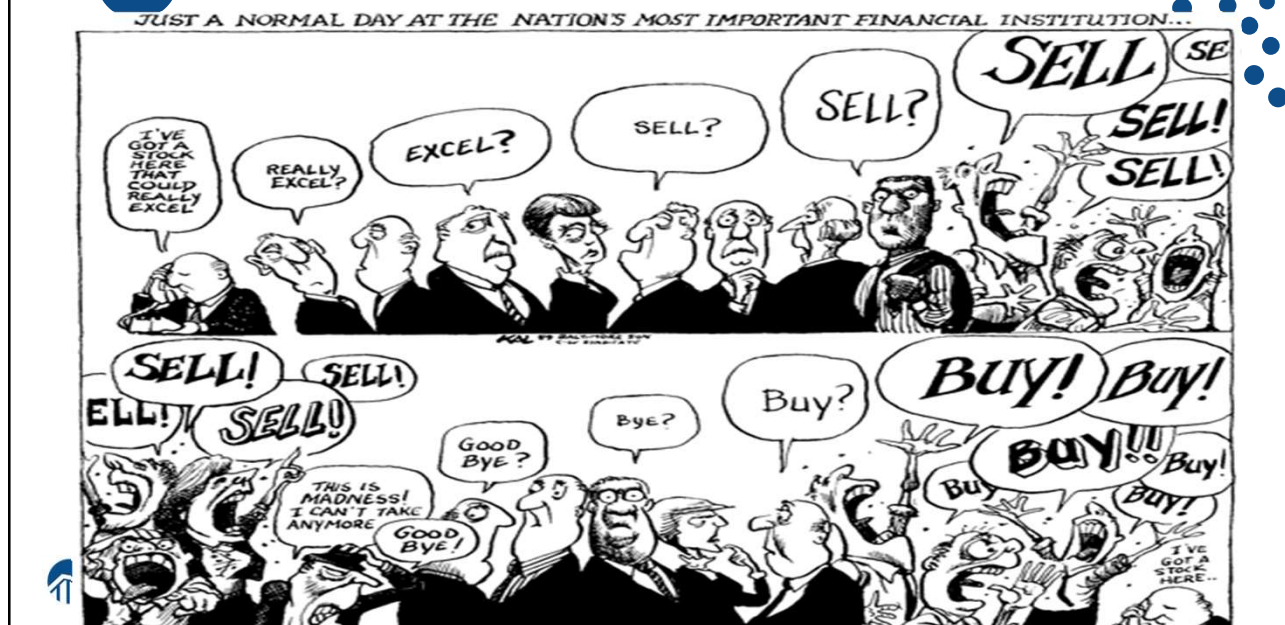
## Why Finance is Fragile II

- Excessively weight recent experience (myopia)
- Individuals trade on noise ('animal spirits') rather than on fundamentals
- Exhibit positive feedback (buy when prices are high, sell when prices are low)
- Finance depends on information and trust: both subject to change. Shocks happen!



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## Positive Feedback in Action



## La Plus ca Change...

- “When the rest of the world are mad, we must imitate them in some measure.” John Martin, Martin’s Bank, 1720 – his bank bought South Sea Company stock in that famous bubble.
- “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” Chuck Prince, ex-CEO, Citibank, July 2007, right before the market froze in August, ‘07
- **But the music already had stopped...mortgage default rates had started rising the previous winter.**



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## Banking is fragile

- **Demandable debt, term transformation risky**
  - ✓ No runs on mutual funds except due to fraud or theft
- **Leverage: Other people's money**
- **Banks are opaque**
- **Sensitive dependence on initial conditions**
  - ✓ Banks = a given set of assets, skills, information and existing regulations and markets.
  - ✓ When the environment changes:
    - Value of assets, skills and information impacted
    - Mistakes almost inevitable



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## Finance gets riskier when:

- **Information problems rise**
- **Economic volatility rises, policy regimes change**
- **Rewards rise -- macro booms**
- **Markets are small or shrink**
  - ✓ Or change dramatically (e.g., new era)
- **Regulations change**
- **When financial reforms are poorly sequenced**
  - ✓ Politicians like cheap, easy, quick reforms
- **When leverage is high/rising sharply**



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## Finance is Riskier in Emerging Markets

- **Greater information problems**
- **Generally smaller size of market**
  - ✓ **Smaller markets** ⇒ more real, nominal, & financial volatility
- **Regime shifts – generally bigger swings in economic policy, perhaps due to bigger shocks**
- **Domination of banking and debt finance, usually short term** ⇒ firm's financing is riskier!
- **Poorly sequenced reforms**



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## From Good Bankers to Bad Bankers

- **Technical mismanagement. Most popular mistakes:**
  - ✓ *Mismatched risk*: too much term transformation or FX risk
  - ✓ *Concentrated risk*: lend too much to single or (cor-)related borrowers
- **Cosmetic mismanagement**
  - ✓ *Evergreening*: "All new loans are good, as have not had time to go bad yet."
  - ✓ *Upside down income statement*:
    - Normal P&L statement**: start with revenues (interest and fees received), subtract costs (interest paid and other costs), pay taxes, and decide how much to retain, paying the rest as dividends.
    - Fake P&L**: start with the dividends needed to pay to avoid suspicion, then invent the other numbers, such as by showing as interest received interest due but not paid



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## Good Bankers to Bad, II

- Desperate mismanagement
  - ✓ Taking very high risks with depositors' funds is legal (though literally gambling is not).
  - ✓ Pay high rates of return to get more deposits, make more high-risk loans or investments, and hope to survive (Ponzi Finance, or almost a Ponzi Scheme)
- Fraud, flight or other exit: stealing money from the bank and leave the country, or committing suicide the final options. Or jail
- Texas S&Ls' example

## Disinformation Pays Well: auditors' conflict of interest when they get big consulting fees, in effect a bribe for a positive audit

### What the Top 25 Pay Their Accountants ...

... And what they pay them for

3-13-02  
Weeks 1 & 2

	Firm	Audit fees	Other fees		Firm	Audit fees	Other fees
Citigroup	KPMG	\$26.1M	\$24.6M	Wachovia	E&Y	\$2.1M	\$1.1M
J.P. Morgan Chase	PWC	\$21.3M	\$84.2M†	First Union	KPMG	\$7.3M	\$24.9M†
Bank of America	PWC	\$13.2M	\$36.3M†	Golden State	KPMG	\$1.9M	\$1.0M
Wells Fargo	KPMG	not available		BB&T**	Andersen	\$0.7M	\$0.9M
Bank One	KPMG	\$4.4M	\$2.5M	SouthTrust**	Andersen	\$0.5M	\$1.7M
Washington Mutual	Deloitte	\$2.9M	\$7.5M	Regions	E&Y	\$0.7M	\$3.0M
FleetBoston	PWC	\$8.6M	\$33.0M†	Golden West	Deloitte	\$0.5M	\$0.2M
SunTrust*	Andersen	\$1.5M	\$4.1M	Comerica	E&Y	\$0.5M	\$1.7M
KeyCorp	E&Y	\$1.8M	\$8.1M	Fifth Third	Deloitte	\$0.7M	\$2.7M†
National City	E&Y	\$1.9M	\$3.0M	AmSouth	E&Y	\$0.9M	\$4.0M
U.S. Bancorp	E&Y	not available		MBNA	E&Y	\$1.1M	\$2.6M
Bank of New York	E&Y	\$1.3M	\$4.1M	State Street	E&Y	\$0.7M	\$7.1M†
PNC	E&Y	not available		Charter One	Deloitte	\$0.4M	\$3.1M†

From most recent proxy filings. Figures are rounded. \*SunTrust said in February it would replace Andersen as auditor. \*\*BB&T and SouthTrust said they would keep Andersen. †Includes information systems consulting.

Source: Bowman's Accounting Report, Atlanta



## In Sum: Causes of Crises

Birds' Eye View

- Excess leverage, mismatched risk, concentrated risk
- Macro cycles – euphoria, then panic
- New Era (change in relative prices, technology, ‘this time is different’ thinking)
- Information problems conceal vulnerabilities until they become too big to hide
- Complacent, compliant or overwhelmed regulators



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## Crisis Prevention: Or At Least, Crisis Mitigation

“It ain’t what you don’t know that gets you into trouble. It’s what you do know that ain’t so”

Mark Twain



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## **Why** Doesn't Regulation Prevent Crises?

- The economics is complex.
- The legal, accounting, and political components are complex.
- And, all of the ingredients are changing
  - Financiers innovate.**
  - Lobbyists lobby.**
  - Political constituencies gain and lose power.**
- Complexity and changing ingredients lead to mistakes.



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## **But,** its not just complexity

- Iceland, Ireland were not hard to see coming.
- NINJA loans (U.S.) were not a secret.
- Financial regulators too often choose policies in the best interests of the financial services industry.
- Central problem of financial regulation: getting regulators to act in society's interest.



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## Is it regulatory capture?

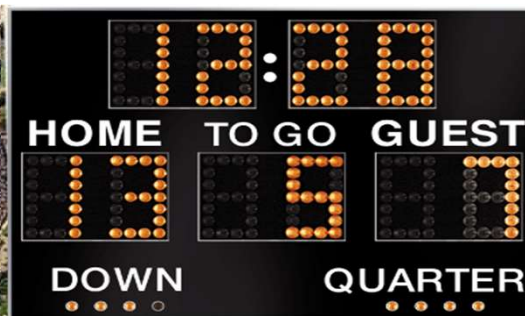
The revolving door.

Examples:

- ✓ NY Federal Reserve Presidents
- ✓ Rubin, Paulson, others at Treasury
- ✓ SEC executives
- ✓ HBOS CEO, ....

But many just doing their best... just like with sports referees?

## Why is there a home team advantage?



## Is it human nature?

Officials are not corrupt; they are human, and sub-consciously please the home crowd.

- Officials do not *reluctantly* change their *stated* views
- They *genuinely* adopt the crowd's view
- Conformity changes their *actual* perceptions

The financial services industry has the home field advantage.



## Why might regulators be biased?

It could be:

- Regulatory capture
- Psychological conformity

But, this only explains their incentives.

What accounts for their ability to act on these biased incentives?



## Why did it happen?

Why didn't the public *compel* the regulators  
to work in society's interest?

It can't...

- It can't obtain an informed, expert, and independent assessment of regulation.
- Therefore, it can't even begin to govern regulators effectively.

**Regulators have a monopoly on the information and expertise,  
and accountability is flawed**





35

## Possible remedies

- **Better incentives for bankers**
  - ✓ **Liability limits? Deferred bonuses?**
- **Better incentives for regulators**
  - ✓ **Independent monitoring group -- instant replay**
- **Simpler rules to permit greater accountability**

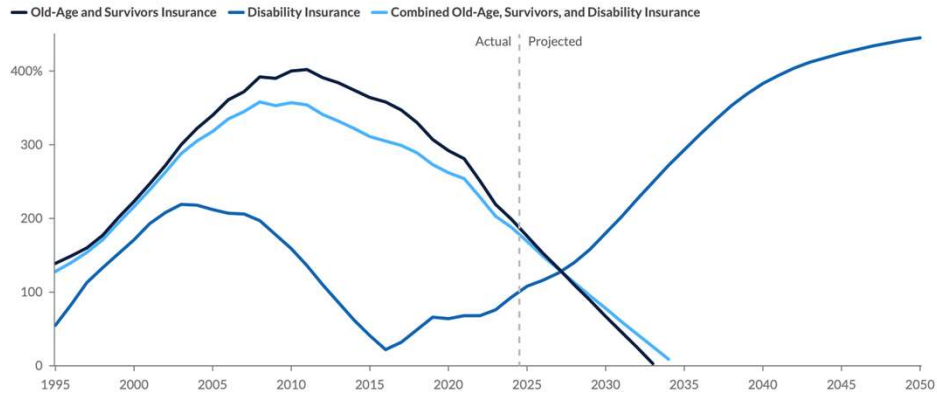


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# Next: Saving Social Security

## Social Security's retirement fund will be depleted in eight years

Asset Reserves at the Beginning of Calendar Year (% of Annual Cost)



Source: Social Security Administration • Embed • Download Image

Note: Under law, a trust fund cannot incur a negative balance. The OASI Trust Fund will be depleted in 2033 while the DI Trust Fund will not be depleted within the 75-year long-range projection period. Combined, the trust funds would be depleted in 2034.



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37

# Thank you!

## Any Questions?

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38